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PRESENTATION

Operator

Good day. My name is Renz, and I will be your conference operator today. At this time, I'd like to welcome everyone to the Rite Aid Third Quarter Fiscal 2020 Earnings Conference Call. (Operator Instructions)

I would now like to turn the call over to Mr. Byron Purcell, Vice President of Investor Relation and Treasury. Sir, please go ahead.

Byron Purcell - *Rite Aid Corporation - Senior Director of Treasury Services & IR*

Thank you, Renz, and good morning, everyone. We welcome you to our third quarter earnings conference call. On the call with me today are Heyward Donigan, Chief Executive Officer; Jim Peters, Chief Operating Officer; and Matt Schroeder, Chief Financial Officer.

On today's call, Heyward will provide the introduction comments, both Jim and Heyward will provide an update on the business, Matt will provide an update on the third quarter results, and then we will take questions.

As we mentioned in our release, we're providing slides related to the material we'll be discussing today. These slides are provided on our website, www.riteaid.com, under the Investor Relations information tab. We will not be referring to them in our remarks, but hope you'll find them helpful as they summarize some of the key points made on the call.

Before we start, I'd like to remind you that today's conference call includes certain forward-looking statements. These forward-looking statements are presented in the context of certain risks and uncertainties that can cause actual results to differ. These risks and uncertainties are described in our press release, in Item 1A of our most recent annual report on Form 10-K and our other documents that we file or furnish to the Securities and Exchange Commission.

Also, we will be using certain non-GAAP measures in our release and in the company's slides. The definition of the non-GAAP measures, along with the reconciliation of the related GAAP measure are described in our press release and in the slides.

With these remarks, I'd like to now turn it over to Heyward.

Heyward Rutledge Donigan - *Rite Aid Corporation - CEO & Director*

Thank you, Byron, and thanks to everyone for joining us. On last quarter's call, I acknowledged that our work here at Rite Aid Corporation should be considered a turnaround. After 4 months on the job, it remains clear that this turnaround will take some time, especially for a company of this size and scale. However, there are early signs that we can make important progress along the way. This year, the company has introduced an entirely new leadership team, some who are new to role that have been here for many years and some who are new to Rite Aid Corporation. Together, this newly formed team has been hard at work defining our go-forward strategy. We are planning an Analyst Day on March 16 and are excited to share more with you then. And it's important to note that this leadership team is focused on more than just strategy development. We are challenging convention every day. We are not letting perceived barriers get in the way. We're approaching our work in overcoming obstacles with ingenuity and agility to drive results. And I'm really pleased with the progress we've made in such short order. As a result, we're pleased to report a strong quarter. Accomplishing results like this even before implementing our strategic plan reinforces my confidence in our company's future.

Now for the quarter's highlights. We delivered a $15.3 million increase in adjusted EBITDA, our biggest increase in over 2 years. This EBITDA growth occurred in both segments of our business. On the Retail Pharmacy side, our store teams continued to focus on delivering best-in-class clinical pharmacy services. This was highlighted by solid growth in flu and ancillary immunizations year-over-year, which helped drive our script count increase for the quarter. And when excluding tobacco-related products, front-end comps grew by 1%.

At EnvisionRxOptions, revenue increased nearly 6%, thanks to growth in our Medicare Part D membership. And improved pharmacy network management helped drive increased adjusted EBITDA for the segment.

Overall, we saw positive results managing expenses, and we will continue to keep that focus heading forward. We also took important steps to retire debt during the quarter. We will continue to prioritize improving our leverage ratio and our capital structure.

We know 2 strong quarters is not enough. We have been moving quickly and aggressively to evaluate all aspects of our business and ensure our strategy is bold yet achievable. We have conducted extensive research, focusing on retail consumers, PBM clients and PBM prospects as well as digging deep to understand our competitors' value propositions to both consumers and clients. This research has informed us as we consider our Rite Aid brand positioning, our merchandising, the design of our stores and our new omnichannel experience for Rite Aid consumers.

We are focused on enhancing the role that our pharmacists play in delivering clinical solutions to our consumers. We're pursuing strategic partnerships with health plans and providers to help them better engage consumers on their health care journey as we are on the front lines of health care delivery in America.

Finally, we are investing in the expansion and integration of EnvisionRxOptions, particularly in services, technologies and clinical offerings. This will provide us scale to deliver total low-cost care and enhanced client experience and heightened consumer engagement. We're preparing to roll out our strategy in March, and I'm looking forward to sharing details about our long-term vision with you.

At this time, I'm pleased to introduce Jim Peters, our new Chief Operating Officer, to share additional details about our third quarter performance. First, just wanted to note, Jim is a dynamic executive with 25 years of health care and industry experience, including health innovation, corporate development, strategy and health care provider payer operations. His strong health care background includes 12 years as a senior executive at Geisinger Health System. There, he helped establish Geisinger's national reputation for health care innovation. He had enterprise-wide responsibility for Geisinger's entrepreneurial businesses, including retail and specialty pharmacy, retail clinics, health care data analytics, digital diagnostics, lab and telehealth. And he led Geisinger's corporate development efforts, striking notable co-development partnerships with global pharmaceutical and technology companies, which resulted in a suite of digital health tools targeting medication adherence, care coordination, patient telemonitoring and family caregiver support. Through Jim, we now have an entrepreneurial leader with deep experience in areas that will be game-changing for Rite Aid Corporation and help us revolutionize our business.

Now I will turn it over to Jim. Jim?

James J. Peters - *Rite Aid Corporation - COO*

Thank you, Heyward, and thanks again to everyone for joining our call. I'm thrilled to be here and sincerely appreciate the warm welcome I've received from the Rite Aid team. I came here knowing that Rite Aid Corporation faces significant challenges, and I came here because of those challenges, not in spite of them. These challenges also represent tremendous opportunity. This is a turnaround and a chance to do some amazing work. It's certainly an opportunity to significantly enhance shareholder value. It's also a chance to redefine what our industry looks like, and it's an important opportunity to make a positive health impact on the lives of millions of Americans.

Success on this scale requires hard work, grit and belief. After working in the trenches with members of our team during my first couple months, I'm confident our associates have developed a newfound appreciation for the challenges we face. We have a clear line of sight to the opportunities in front of us. We are tackling challenges and addressing opportunities with focus, speed and confidence. We understand the bold mindset required to make the changes necessary for sustainable long-term growth.

We recognize that we are in this together and that our shared success won't come easy, and it certainly won't come overnight. And after taking a deep dive into developing our long-term go-forward strategy, I'm fully convinced that the issues we are facing are solvable, not simply to survive, but to thrive. We are equally bullish on the unique capabilities we offer through EnvisionRxOptions. As Heyward said, we are preparing to roll out our new strategy, and I, too, look forward to sharing additional details with you on March 16.

To be clear, it's not business as usual at Rite Aid Corporation. We have developed a strategy that is comprehensive in scope and bold in design. We are turning over every rock in every corner of the company. We are improving upon what works, and we are changing what is not. The work has already begun and will continue in earnest.

As everyone on this call knows, the time and now and we are wasting no time and laying the cornerstones that will make Rite Aid Corporation more relevant to the consumers of today as well as the consumers of tomorrow.

Now let's talk about Rite Aid, the Retail Pharmacy. Our pharmacists and pharmacy offering are at the heart of our consumer experience. With the leadership and support of our Chief Pharmacy Officer, Jocelyn Konrad, we are making real changes that will drive both tangible health outcomes and deep loyalty as consumers recognize their pharmacists as more than just a dispenser of medication, but as a valuable and constant extension of their care team.

The reality is many of our consumers engage with our pharmacists far more often than they do with their own physicians. And as you know, pharmacists consistently rank among the most trusted health care providers. In just 2 months, we have hardwired the lean mindset and methodology throughout Rite Aid Corporation and using what we learn to free up pharmacists' time for more meaningful interactions with consumers.

We are expanding the capabilities of our digital engagement platforms, in-store consumer experiences, Rite Care clinical services platform, medication adherence programs and our central fill capabilities. All this means more time for more meaningful and personalized consumer health interactions. And this means better health outcomes and overall experiences for our customers, which drives, of course, greater affinity and loyalty. Our pharmacists want this. Our consumers want this. And we hear loud and clear that our health plan and health system partners want this as well. We know that achieving this goal has tremendous potential, and we are laser-focused on making it happen.

In terms of our business today, we understand the reimbursement pressure we're facing. And while the environment continues to be challenging, we have secured contracts with all major PBMs and now have a clear line of sight on rates through the end of calendar year 2020. There are also key areas of momentum that we can build upon heading forward. When adjusted to 30-day equivalents, we grew same-store prescription count by 2.8% over the prior year period, driven largely by our success with clinical pharmacy services. Our store teams have been highly engaged in our annual flu immunization campaign.

By the end of the quarter, our pharmacists had already administered more than 2.3 million flu shots, which is ahead of plan and more than we administered all of last year. Our proprietary Rite Care technology has emerged as a true differentiator, helping us protect more consumers from conditions like pertussis and shingles and provide them with medication therapy management services as well. We've seen the benefit of Rite Care in our business and our third quarter results, which reflect growth in ancillary immunizations of more than 47%, which is outpacing our competition. And our results for medication therapy management are both exceeding plan and ahead of last year's results.

Moving forward, expanding our clinical service offerings is vital to continuing to establish our pharmacists as an increasingly important member of our consumers' extended care teams. In between physician visits, we see consumers more frequently relying on our pharmacists who more regularly coach, counsel and guide our consumers' health choices and clarify their increasingly complex care journeys. Consumers place high trust in their Rite Aid pharmacists and value the strong relationships they have established with them. We will leverage these touch points of strength to more formally and visibly establish our role in amplifying the efforts and impact of our physician and health plan partners.

Now in addition to our work in the pharmacy, we are taking big steps in our approach to front-end merchandising. Whole being health does not end with the pharmacist. It will carry through to a more curated selection of merchandise and an engaging retail experience that is conducive to retaining and gaining new consumers in a competitive landscape. We will provide retail products, services and experiences that truly enhance the well-being of our consumers. We are thoroughly evaluating every product category and every SKU to understand what we should expand, enhance, reduce or eliminate. We're already taking some initial steps by revamping our endcap displays in a way that's influenced more so by consumer preferences. And there is much more to come over time.

As we begin this process, it's encouraging that our front-end performance exceeded our expectations in Q3. Excluding cigarettes and tobacco-related items, comps increased 1.0%, primarily due to a strong start to cough and cold season. Q3 owned brands penetration, as currently defined, was 19.2%, an increase of 89 basis points over last year. We continue to have a focus on own brands growth and will evolve our own brands portfolio on packaging, with the goal of redefining our brands in FY '21.

It's also worth noting that Thrifty Ice Cream, which we recently expanded to 900 additional stores, was a meaningful contributor to our third quarter growth. Our marketing strategy will undergo dramatic changes moving forward. We are rapidly modernizing our digital and omnichannel consumer engagement infrastructure as a key part of that strategy. We are going to give consumers what they want, when they want it, regardless of where they are. And we are executing our plan for digital personalization, reducing reliance on printed circulars and taking a hard look at our customer loyalty program. These foundational steps will better optimize marketing investments, provide rich consumer insights and help us to acquire new customers. And already, we are seeing promising preliminary results from initial campaigns supporting flu shots, for example.

And digital sales have been growing over the past few quarters, with a 69% increase in Q3, driven by digital refills. Heading forward, we are releasing a new online and mobile solution, which will fully personalize and streamline consumer experience. These efforts are critical to securing the loyalty of the next generation of Rite Aid customers.

A new approach to pharmacy merchandising and marketing means that our consumers will expect compelling in-store and digital experiences. We will elevate and differentiate our stores in the months and years to come and provide a unique best-in-class retail experience. This includes reimagining our drive-throughs, enhancing our delivery services and introducing new pickup experiences like pay and go and buy online, pick up in store. These experiences will be supported by investments in technology to completely modernize our digital capabilities and provide a seamless omnichannel experience throughout the pharmacy and front-end.

In terms of ongoing initiatives, we were early adopters for Amazon Counter and Locker and will very soon offer an Amazon Pickup solution at every Rite Aid store. In addition, consumers are responding positively to self-checkout, which is currently active in 100 stores throughout New York City and Los Angeles. We are seeing increased customer counts while controlling expenses and delivering an enhanced checkout experience. We plan to introduce self-checkout at 200 additional stores during the first half of calendar 2020.

Before I turn it back over to Heyward, I would like to thank our team at the Rite Aid Corporation for their great work during the quarter and their deep commitment to serving our customers. In the short time I've been with the company, I am quite impressed with the many service behaviors I have witnessed, and I am proud to work with such a caring team. I came to Rite Aid Corporation with a fresh set of eyes. From where I sit, it seems clear that for our company, the past several years represent a period where action or inaction was driven by a focus on being sold. This focus, as is often the case, resulted in a "don't rock the boat" mentality as the team drove toward finalizing those deals.

As you can probably sense, our direction has changed course 180 degrees. We are focused on our bright future with renewed energy and optimism. We are an independent entrepreneurial company with hungry, battle-ready associates. And I assure you, we're not going to wait around and let others dictate our future. We will author it ourselves. We will drive the change. We will own the results. I'm excited to be working alongside our more than 50,000 associates as we strive to exceed the needs of our customers and take the next steps in executing our long-term strategy.

Thank you so much for your time today. With that, for some additional comments on EnvisionRxOptions, I will now turn it back over to Heyward.

Heyward Rutledge Donigan - *Rite Aid Corporation - CEO & Director*

Thanks, Jim. Before we discuss results for the quarter, I wanted to highlight some of the important progress we're making to fully capitalize on the opportunity we have with EnvisionRxOptions. EnvisionRxOptions is one of our most important assets, and we're bullish on its growth potential. Up to this point, Rite Aid and EnvisionRxOptions have largely operated as separate entities. During the quarter, we began to take significant steps toward building tighter organizational alignment and realizing greater operational synergies. We've begun the process of integrating our technology infrastructure, standardizing both associate benefits and other back office functions to streamline costs, processes, and foster strong operational collaboration. And this work is just beginning, and we believe there are additional opportunities in 2020 and beyond.

We need to do this, though, without impacting EnvisionRxOptions' ability to be flexible and innovative. Given our new direction, we've also taken a close look at the leadership and organizational structure at EnvisionRxOptions. We eliminated the CEO position. And earlier this week, we appointed Dan Robson as the President of EnvisionRxOptions. Dan most recently served as President of EnvisionRxOptions' subsidiary, MedTrakRx. He is a proven leader with more than 30 years of health care, pharmaceutical and lab industry experience in operations, product development, clinical services and revenue generation. We're pleased to have found an internal candidate who truly understands our business and can immediately support efforts to bring our 2 organizations closer together.

The EnvisionRxOptions team did a great job of delivering growth during a time of significant change. Third quarter results were strong, with adjusted EBITDA increasing by $7.9 million or 19.1% compared to the third quarter of the prior year. This increase was primarily driven by a continued focus on improving margins, including our significant efforts to optimize our network strategy.

Revenue was favorable to prior year by $87.3 million or 5.7%. This increase in revenue is principally due to an increase in Medicare Part D membership. Medicare Part D enrollment is up 19% year-over-year with a total year-over-year increase of approximately 114,000 members.

In summary, we now have over 700,000 Medicare Part D members, including over 380,000 choosers. We experienced good results for the recent Medicare Part D annual enrollment period for calendar year 2020, with net growth of over 140,000 Medicare Part D members for the month of January 2020. Also, our Envision mail order pharmacy specialty revenues are up 27% year-over-year. And specialty claims are up 24% over prior year, primarily due to the increase in Medicare Part D members.

Finally, the 2020 commercial selling season was strong, having won over 300,000 new lives. We have also secured renewals for many of our key clients. And even with some losses that we consider outliers, our membership retention rate is 90%. Our position as a strong independent PBM is resonating as an essential option in the marketplace for health plans, health systems, self-insured employers and unions. We're excited about our opportunities for the 2021 commercial selling season. Dan and I look forward to sharing our EnvisionRxOptions strategic plan with you in March.

With that, I'll now turn it over to Matt for some comments on our Q3 financial performance. Matt?

Matthew Schroeder - *Rite Aid Corporation - CFO*

Thanks, Heyward, and thanks to everyone for joining us today. On this morning's call, I will walk through our third quarter results, provide a recap of our recently completed bond repurchase and review our fiscal 2020 guidance.

Revenues for the quarter were $5.5 billion, which were up approximately $12 million from the prior year's third quarter. Adjusted net income in the current quarter was $29.1 million or $0.54 per diluted share versus adjusted net income of $14.7 million or $0.28 per diluted share in the prior year quarter. The improvement in our adjusted net income was due to an increase in adjusted EBITDA, which was $158.1 million in the current quarter compared to $142.8 million in the prior year quarter.

Retail Pharmacy Segment revenue for the quarter was $3.9 billion, which was $66.8 million lower than last year's third quarter. Our decrease in Retail Pharmacy Segment revenue was driven by the 62 stores that we have closed since the end of last year's third quarter. Same-store sales decreased 10 basis points in the quarter. Front-end same-store sales were down 50 basis points, but up 1% when excluding cigarette and tobacco sales, driven by strong results in core categories such as upper respiratory, beverages, pain care and vitamins. Pharmacy same-store sales increased 10 basis points, with same-store prescription count up 2.8% on a 30-day adjusted basis due to the success of our clinical initiatives and immunization programs.

Total Retail Pharmacy Segment gross profit dollars in the quarter were $8.7 million worse than last year's third quarter, but gross margin was 24 basis points better as a percent of revenues. Adjusted EBITDA gross profit was unfavorable to last year's third quarter by $22.7 million and 11 basis points worse than prior year as a percent of revenues.

Our decline in adjusted EBITDA gross profit was driven by declines in both pharmacy and front-end gross profit dollars. The front-end gross profit dollar decline was driven by increases in markdown dollars due to weak summer and back-to-school seasonal sell-through and lower vendor promotional funding.

The pharmacy gross profit decline was driven by reimbursement rate adjustments resulting from the finalization of a contract with one of our payers. Retail Pharmacy Segment SG&A expense for the quarter was $18.4 million lower and flat as a percentage of revenues to last year's third quarter. Our adjusted EBITDA SG&A was $3 million and 35 basis points better than last year. In addition to our ongoing strong labor control through all parts of the retail business, we had favorable results in medical, workers' compensation and general liability expense. These items more than offset lower TSA fee income from Walgreens.

Our Pharmacy Services Segment, EnvisionRxOptions, had revenues of $1.6 billion, which was an increase of $87 million or 5.7% due to an increase in our Medicare Part D revenues as we continue to grow our membership. Adjusted EBITDA for the Pharmacy Services Segment of $49.5 million was $7.9 million better than last year's third quarter adjusted EBITDA of $41.6 million. Pharmacy Services Segment adjusted EBITDA benefited from improvements in Pharmacy Network management, partially offset by increases in SG&A expense related to our growth in Medicare Part D membership.

Our cash flow statement for the quarter shows a source of cash from operating activities of $424 million in the current year quarter compared to a source of cash from operating activities of $351 million in the prior year quarter. The cash from operating activities in the quarter was due to the receipt of our 2018 Medicare Part D receivable from CMS, the results of initiatives to better manage front-end inventory and trade payables and other timing differences.

Our debt balance, net of cash, was approximately $3.3 billion at the end of our third quarter, and our pro forma leverage ratio was 5.9x adjusted EBITDA, which takes into account the pro forma impact of proceeds from the sale of the remaining distribution centers to Walgreens.

Subsequent to the end of the quarter, we finalized the sale of 1 of the 2 remaining distribution centers to Walgreens. We received proceeds of $24 million for the sale of the related inventory in the third quarter and $39 million related to the sale of the facility in December. We will finalize the sale of the other distribution center before the expiration of the TSA agreement in October of 2020.

During the quarter, we also repurchased $156 million of our 2027 and 2028 notes for an aggregate purchase price of $100 million. We recorded a gain on debt retirement of $56 million on this transaction and reduced our total debt outstanding by the same amount. Our liquidity of over $1.5 billion at quarter-end is very strong. And with no debt maturing until 2023, we have the flexibility and the runway to execute our strategic initiatives.

Now let's turn to our fiscal 2020 guidance which we are updating at this time. Our guidance assumptions for the Retail Pharmacy Segment for the remainder of the year reflect expectations for continued prescription count growth, generic drug cost savings and strong SG&A expense control, offset by continued reimbursement rate pressure.

Our guidance for the Pharmacy Services Segment assumes sustained improvements in pharmacy network management and initial benefits from SG&A reduction, benefits integration and restructuring initiatives. We expect total revenues to be between $21.5 billion and $21.9 billion and same-store sales to be in a range of flat to an increase of 1%. We expect net loss to be between $174 million and $204 million. We expect adjusted EBITDA to be between $515 million and $545 million, and expect adjusted net income per share to be between $0.13 and $0.55 per share.

Our fiscal 2020 capital expenditures are expected to be $230 million and will be concentrated on prescription file buys and investments in technology that will drive growth. We have scaled back our spend on remodels in fiscal 2020 from earlier estimates as we finalize our strategic planning.

As previously noted, we are planning to host an Analyst Day on March 16 in New York City, at which time we will provide further details on our strategic initiatives and will provide guidance for fiscal 2021.

This completes my portion of the presentation. And with that, we will now be opening the phone lines for your questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Your first question comes from the line of Lisa Gill from JPMorgan.

Lisa Christine Gill - *JP Morgan Chase & Co, Research Division - Senior Publishing Analyst*

First, I just want to start, Heyward, you talked earlier about clinical pharmacy services and programs that you have and you discussed flu. But beyond flu, can you talk about what kinds of programs that you have today? And I know that there continues to be reimbursement pressure and there's been talk over the last couple of years of potential changes in the way that pharmacies are reimbursed. Are you seeing any changes in your contracts to start to account for some of these types of clinical programs? Or are you just seeing it more in the prescription count of people coming into the store?

Heyward Rutledge Donigan - *Rite Aid Corporation - CEO & Director*

We're actually in the process of -- and thank you, Lisa. We're in the process of revamping the way that we go to market as a pharmacy providing clinical services. And I'll let Jim comment specifically on that, along with the trends that we're seeing in the marketplace.

James J. Peters - *Rite Aid Corporation - COO*

Thanks, Lisa, and nice to meet you. Yes, it's a good question. And while we'll reveal kind of far more detail as we approach and engage in Analyst Day, beyond flu, we're seeing immunizations and ancillary immunizations, which has been, as I mentioned earlier, very strong for us in pertussis and shingles, in particular. Beyond that, we see the pharmacist role expanding, as I mentioned earlier, in ways that can help us be more logical and, frankly, a more frequent extension of the care team in between physician visit, so more to come on that, but we feel good that beyond pure script growth, we are positioned to perform quite well from a clinical services perspective.

Heyward Rutledge Donigan - *Rite Aid Corporation - CEO & Director*

And we don't necessarily see "reimbursement change," although I think that, that might happen over time, and we're seeing evidence of folks in Washington as well as at the state level viewing the pharmacist as a natural extender of health care on the front lines of America and witnessing that allowing us to provide more services, for example. But I think our core strategy is really to go to the heart of who really benefits from this, and that is the payers, from the point of view -- as well as the providers from the point of view of them needing a frontline health care provider to provide additional access to low cost, high-quality services on the front lines. And we think the pharmacists in our particular space are uniquely positioned to provide that. And so we will talk more about that in March, specifically.

Lisa Christine Gill - *JP Morgan Chase & Co, Research Division - Senior Publishing Analyst*

Along those lines, when we think about preferred networks, whether it's for Medicare or for commercial, where do you stand for 2020? Are you participating in any preferred networks on the Medicare side? And then secondly, are you starting to see any movement on the commercial side for preferred networks?

Heyward Rutledge Donigan - *Rite Aid Corporation - CEO & Director*

We are currently assessing our preferred network status in the Medicare Part D, particularly networks, and we are looking at that now on a market by market, PBM by PBM basis. So work in progress. We are very, very interested and aggressively pursuing participation in the commercial lines of business, especially where we have these clinical partnerships. So again, more to come on that, but this is something that we're actively working on.

Operator

Your next question comes from the line of Robert Jones from Goldman Sachs.

Kevin Hartman - *Goldman Sachs Group Inc., Research Division - Business Analyst*

This is Kevin on for Bob this morning. So EBITDA this quarter was pretty strong compared to both consensus and the year-to-date run rate. But guidance for the full year was unchanged at the midpoint. I was just wondering if there was any sort of onetime or timing-related benefit in the quarter that you'd point out? And then building off that, it seems like guidance also at the midpoint would imply like a relatively meaningful step down in 4Q compared to 3Q. Can you talk to any of the drivers of what might drive that step down?

Matthew Schroeder - *Rite Aid Corporation - CFO*

Yes. Sure, Kevin. It's Matt. So I think first of all, Q3 is always a really big script quarter for us with all the work that we do with flu immunizations, so that's a driver. The one thing I would call on the expense side that has a bit of a onetime element to it is we do take a hard look at kind of our valuations for self-insurance in the third quarter of every year. And while we expected to do well from a kind of claims control standpoint, that number came in a little better than what we thought. And so there's an element in Q3 of kind of a true-up for that workers' compensation expense that's more weighted to the third quarter than it is for the rest of the year, and that had an element.

As far as the fourth quarter, the only thing -- other thing I would point out is we do have a reset of rates at the beginning of January in our retail business that typically has a bit of a drag on our results. And if you think about how kind of the cadence of our pharmacy margin works, we had a reset of rates in January. And then we don't typically get the benefits of our bid with McKesson until a little later in the spring. So there's a little bit of a negative impact on the fourth quarter that happens in our pharmacy gross profit because of that. And so that's the reason for the kind of implied guidance for the fourth quarter that's in our numbers.

Kevin Hartman - *Goldman Sachs Group Inc., Research Division - Business Analyst*

That's really helpful. Just, I guess following up a little bit on that. I think you guys had said that you have a clear line of sight now on what reimbursement pressure for calendar 2020 will be at this point. Can you maybe just give us any sense of how this would compare just like the overall reimbursement pressure to what you faced in calendar '19?

Matthew Schroeder - *Rite Aid Corporation - CFO*

Yes. Kevin, that's a great question, but I want to defer that until we come out with guidance for '21 and talk about that in the totality of our whole numbers because it's just a piece of the puzzle. And we have great line of sight from a contract standpoint. Candidly, we have a better idea once we kind of get into when we're giving you guidance on kind of how mix works between networks, which is another reason I think it's best for us to just to kind of hold off on giving too much color on that until we get to the fiscal '21 guidance discussion.

Operator

Your next question comes from the line of Glen Santangelo from Guggenheim.

Glen Joseph Santangelo - *Guggenheim Securities, LLC, Research Division - Analyst*

My question is kind of for Jim and Matt. It's like a financial investment question. If I look at your adjusted EBITDA guidance of, let's call it $530-ish million at the midpoint, if you just look at the current CapEx run rate of about $230 million and your interest expense is also $200 million and something, it doesn't seem like there is a significant amount of leftover free cash flow for further investment. And so Jim, I guess my question is, and I don't want to spoil the March Analyst Day, but could you give us a sense for maybe what you're thinking? I mean do you think the growth plans are going to require CapEx to go up from this level? I think, Matt, you mentioned you have $1.5 billion of liquidity. Do you feel like you have the financial liquidity and resources to elevate that CapEx to invest in the business in a meaningful way? And it kind of sounds like you scaled back the store transitions in the near term. I just want -- if you can give us any sort of clues as to directionally which way you may be heading, that would be helpful.

Matthew Schroeder - *Rite Aid Corporation - CFO*

Yes. Glen, thanks for the questions. This is Matt. I'll start. I don't want to get too far ahead of the Analyst Day and the discussions on the strategy. But I do think that with the $1.5 billion of liquidity we have and with, I think, the ability to find some other creative ways perhaps to raise funds, whether it be a sale-leaseback transaction or something else like that, I do think we have some tools in the toolbox to be able to ramp that CapEx level up from the current run rate if necessary. I don't want to get into giving a specific plan or number. But we do feel confident that we've got the ability to invest in our business.

And the other thing I would point out, Glen, is that some of the stuff that we're doing is not hugely capital intensive. I think there's a ton of work that Justin Mennen and his team are doing on the digital side that requires investment but is not something that's like a heavy CapEx lift. And I think that's something else to keep in mind.

Heyward Rutledge Donigan - *Rite Aid Corporation - CEO & Director*

Yes. Well, it's Heyward. I'll jump in. We have a very strong level of confidence in the plan that we're going to put forward in March around exactly that, that will allow us to ramp up our CapEx spend while still reducing leverage ratio.

Glen Joseph Santangelo - *Guggenheim Securities, LLC, Research Division - Analyst*

And Heyward, maybe if I can just follow up with you on the PBM based on some of your comments. It kind of sounds like your net Part D lives are going up by 140,000 in January, and I think you said you have over 300,000 new commercial lives that came out of this selling season, but your membership retention was only about 90%. I'm wondering if you can net all that out for us and give us a sense for net, are you up in 2020 versus 2019 in terms of total covered lives? How should we think about that all sort of netting against each other?

Matthew Schroeder - *Rite Aid Corporation - CFO*

Yes, it's Matt. I'll jump in. I would say we're up. We'll wait until we give full guidance to give a more kind of precise number to that. But with all the puts and takes, we are up in covered lives. It's going to be up in covered lives for plan year 2020 at the PBM.

Operator

Your next question comes from the line of Elizabeth Anderson from Evercore ISI.

Elizabeth Hammell Anderson - *Evercore ISI Institutional Equities, Research Division - Associate*

I'm personally helping to drive some of your comps for December, so I'm sorry about my voice. I was wondering if you could comment a little bit. I know, Matt, you said quantitatively, you weren't willing to comment on the 2020 rates yet. But qualitatively, if you could talk about some of the contractor you guys are seeing with some of the payers, either in terms of some -- digital clinical services but maybe broader than that as you're changing sort of how you approach those relationships.

Heyward Rutledge Donigan - *Rite Aid Corporation - CEO & Director*

I think we were originally referring to -- maybe we need to better understand your question. I think we have 2 things going on: One is the contracts for reimbursement from the PBMs, which is what Matt was saying that he'll give more color on as we go forward. The second is a different set of contract discussions, and that's with payers to use our frontline health care delivery vehicle in our pharmacies to be able to deliver enhanced clinical services. And for that, there is anticipated a separate set of reimbursement. I don't know if that gets to your question.

Elizabeth Hammell Anderson - *Evercore ISI Institutional Equities, Research Division - Associate*

Yes. Sorry, I was talking about it from more from the PBM perspective, if there is anything that you would -- wanted to just point out like qualitatively in terms of some of the changes as you approach those. But your comment was helpful as well.

Matthew Schroeder - *Rite Aid Corporation - CFO*

Yes. Elizabeth, I think we probably need to stay away from getting to in the weeds on kind of the contractual stuff until we get to the '21 guidance. I want to put all the pieces together at one time.

Operator

Your next question comes from the line of George Hill from Deutsche Bank.

THOMSON REUTERS

George Robert Hill - *Deutsche Bank AG, Research Division - MD & Equity Research Analyst*

I guess, Heyward, kind of now that you've been in the seat for a while and you talked a little bit about SG&A cost reductions, I guess can you either quantitatively or qualitatively speak what you've seen with respect to the company's ability to kind of go on a sustained cost cutting program or kind of how far away from lean do you think the organization is? I'll kind of pause there.

Heyward Rutledge Donigan - *Rite Aid Corporation - CEO & Director*

Yes. I mean I think we've already demonstrated a significant ability to move the needle on cost cutting. And this is the area where I frankly have the highest level of confidence because it's completely within our control. So we have the opportunity to, I believe, significantly become more efficient in the field and at corporate here at Rite Aid. And I think we've demonstrated already a significant amount of cost cutting in the restructuring, and we will be identifying some really outstanding results in terms of better managing our inventory levels as well as freeing up our pharmacists' time through lean.

We're also showing -- it's not fully showing in the numbers yet, but we're going to show, I think some very strong results in terms of expense management, in terms of the integration with EnvisionRxOptions and our own organization, Rite Aid. And I believe that is just the beginning of the opportunities that we will see as we further integrate and see synergies between the 2 organizations. Also lean is producing results at EnvisionRxOptions in terms of what we're working on with increased efficiency in our mail order company as well as our implementations. So I think we're going to have a sustainable and continued increase in efficiency as well as a continued opportunity to show results in terms of the synergies between the organization.

George Robert Hill - *Deutsche Bank AG, Research Division - MD & Equity Research Analyst*

Okay. And I guess the follow-up I'll try to sneak in here is, I guess as we think about kind of beyond fiscal '20, can you say at a high level -- I'm trying to think about what the longer-term growth algorithm for Rite Aid looks like given reimbursement pressure and what's going on with narrow networks and scripts. It seems like the goal would be to kind of grow scripts in the low single-digit range. The front-end of the store maybe grows at the same rate. Reimbursement pressure might offset the volume growth. Capital deployment will be a contributor. Matt -- I think Matt's probably going to say this is Analyst Day type question. But just in broad strokes, can you kind of paint what the longer-term growth algorithm looks like for Rite Aid?

Matthew Schroeder - *Rite Aid Corporation - CFO*

George, it's an Analyst Day question. We will get more into the strategic things there. I think the things I would point out from a growth standpoint and the opportunities on a super high level is one, I do believe that we have an opportunity to significantly grow the scripts in our store over time. It won't happen overnight. But we've got some stores in some great locations in the markets where we're in, which frankly, if you look at, their productivity to compare some of our competitors are underutilized. And so I think there's opportunity with the strategies we're going to talk about to drive that up over time.

And the second thing is, I think, the PBM over time in EnvisionRxOptions has significant opportunity for growth as we think about how EnvisionRxOptions approaches the market and the ability to significantly drive PBM top line with a -- with relatively few client wins if they are the right types of client wins. At least when you compare it to try to how you grow retail.

Heyward Rutledge Donigan - *Rite Aid Corporation - CEO & Director*

Yes. And I think with our new merchandise and our online experience and our ability to expand beyond our current markets, we will be able to show good growth there as well.

Operator

Your next question comes from the line of William Reuter from Bank of America.

William Michael Reuter - *BofA Merrill Lynch, Research Division - MD*

The first question on the EnvisionRx commercial lines growth for 2020 selling season. I think the number you quoted today was lower than what you had quoted last quarter. Is that right or did I miss something there?

Matthew Schroeder - *Rite Aid Corporation - CFO*

Yes, bill, it is slightly lower, we had -- as we kind of finalized the lives that came in with the contracts and the estimation of those lives with the wins that we had for 2020, our estimate -- our kind of our final numbers what those lives are going to be are slightly lower than what our estimate was when we last reported.

William Michael Reuter - *BofA Merrill Lynch, Research Division - MD*

Okay. That's helpful. And then can you remind us what the proceeds from the sale of the second distribution center, what the number of that's going to be, including, I guess working capital?

Matthew Schroeder - *Rite Aid Corporation - CFO*

Yes. So the last distribution center, if that's what you're asking about, that goes next year, that -- those proceeds should be somewhere in the range of between $95 million and $100 million. If you look at the slides that we put out and the pro forma leverage ratio calc, you can back out the $39 million that we got for the other -- the DC we just sold in December to get to the precise number.

William Michael Reuter - *BofA Merrill Lynch, Research Division - MD*

Okay. And then just lastly for me, I was, I guess a bit surprised by the bond repurchases, but good to see. I guess how are you viewing additional bond repurchases, whether it's the '23s, '27s or '28s?

Matthew Schroeder - *Rite Aid Corporation - CFO*

Yes. I -- probably not ready to give you like a specific road map there. I think, Bill, we are kind of laser-focused on finding ways to both address the leverage ratio we have outstanding and the debt outstanding. So I think we're going to keep an open mind on a variety of different things we can do there. Don't have a more specific commentary other than that.

Operator

Your next question comes from the line of Carla Casella from JP Morgan.

Carla Casella - *JP Morgan Chase & Co, Research Division - MD & Senior Analyst*

One follow-up on the Envision business. Just trying to understand how much of the Envision business actually comes from the Rite Aid stores, to understand like how integrated those 2 businesses are?

Heyward Rutledge Donigan - *Rite Aid Corporation - CEO & Director*

It doesn't really come from the Rite Aid stores. Our Envision business is largely driven by contracts with commercial employers, small, mid-market, larger and also health plan business. We happen to participate as Rite Aid pharmacies in their networks. But that's really the extent of it.

Matthew Schroeder - *Rite Aid Corporation - CFO*

Yes. I think maybe, Carla, the opportunity goes the other way. So we're a preferred provider in Envision's Med D plan. And that in the markets we're in, provides some incremental traffic, script traffic from the standpoint of us being a future provider.

Carla Casella - *JP Morgan Chase & Co, Research Division - MD & Senior Analyst*

Okay. Great. That's helpful. And then just on the lease termination, you increased the expectation for the lease termination charges, yet year-to-date, it's running very low. Does that imply that there's a big store closing or lease termination planned for fourth quarter?

Matthew Schroeder - *Rite Aid Corporation - CFO*

It does not, Carla. Included in that number is a charge we take every year in the fourth quarter for an evaluation of the cash flows that our stores generate and an impairment charge will often come out of that.

Carla Casella - *JP Morgan Chase & Co, Research Division - MD & Senior Analyst*

Okay. So it's more impairment. Okay. Got you.

Matthew Schroeder - *Rite Aid Corporation - CFO*

It's impairment. It's impairment. We're not anticipating any significant changes in the store count.

Carla Casella - *JP Morgan Chase & Co, Research Division - MD & Senior Analyst*

Okay. A question I haven't asked in a long time. How many dark stores do you have?

Matthew Schroeder - *Rite Aid Corporation - CFO*

Carla, I don't know that off the top of my head. I can get back to you on that. I think the burn rate right now is somewhere in the $40 million to $45 million a year range, with an expectation of that number to come down, step down actually pretty decently over time here in the next couple years.

Carla Casella - *JP Morgan Chase & Co, Research Division - MD & Senior Analyst*

Okay. And then did you disclose the TSA fee that was spent in the third quarter?

Matthew Schroeder - *Rite Aid Corporation - CFO*

We did not. I think we've said in the past that the expectation for the TSA fee for the year is roughly $40 million.

Operator

Your next question comes from the line of Karru Martinson from Jefferies.

Karru Martinson - *Jefferies LLC, Research Division - Analyst*

When we look at the CapEx guidance, it certainly implies a meaningful step-up here in the fourth quarter. Is that going to be all Rx file buys? Or given that we're scaling back the remodels, or is the potential that we can see some of that flowing into next fiscal year?

Matthew Schroeder - *Rite Aid Corporation - CFO*

I think it's a combination of 2 things, Karru. One is Rx file buys. We're starting to see the volume of that pick up in the back half of the year, and that kind of ebbs and flows just in the marketplace, sometimes without rhyme or reason, but we're seeing some pretty strong deal flow there. The other thing is some of our IT spend that we've been referencing is back-end loaded, which also accounts for kind of the differential between what we spent so far this year and the guidance.

Karru Martinson - *Jefferies LLC, Research Division - Analyst*

Okay. And then when you go to look at file buys, are they still in that $10 million to $20 million range?

Matthew Schroeder - *Rite Aid Corporation - CFO*

I would say, in general, yes, but it's really -- and it's really market-driven from the standpoint of when we go and actually look at a particular buy.

Karru Martinson - *Jefferies LLC, Research Division - Analyst*

Okay. And there's been a number of headlines on the opioid litigation. What is Rite Aid's role or -- do you see in this process?

Heyward Rutledge Donigan - *Rite Aid Corporation - CEO & Director*

Well, we don't really comment on the litigation. But I will say that we are very focused on this, and we are seeing an increase in legal fees tied to this. As you can imagine, we do believe that those costs will continue for some time as we defend these lawsuits. And we've included the estimated impact of all these increased fees and costs in our fiscal 2020 guidance.

Operator

Your next question comes from Bryan Hunt from Wells Fargo.

Bryan Cecil Hunt - *Wells Fargo Securities, LLC, Research Division - MD & Senior Analyst*

Well, you got every high-yield analyst in a row there. My questions are 2. One, if I look at EnvisionRx, I was wondering if you could talk about what historical retention rates, you got to 90% for the next year. Can you talk about maybe the disruption and how that historically, as the company has gone their sales processes affected the retention rates at Envision as well as how does that stand relative to your peer group?

Matthew Schroeder - *Rite Aid Corporation - CFO*

Yes, I'll start out maybe with just kind of comment on this year's -- on the rate for 2020. We do have kind of 2 commercial client losses that are a bit of an outlier. One is someone who view themselves as a retail competitor who moved the business; the other one is a health plan that got purchased. And I think if you were to pull those out, you'd have a retention rate that was probably closer to 95%, which I think is a lot more in line where we see our competitors. So that's really the reason for kind of a delta between 90% and 95%.

Heyward Rutledge Donigan - *Rite Aid Corporation - CEO & Director*

This might be a good time to introduce Dan who can comment a little bit on that question. I think, Dan, the new President, meet our high-yield analyst.

Dan Robson - *Rite Aid Corporation - President of EnvisionRxOptions*

So I can address that. So specific to EnvisionRxOptions, specifically for this year we're in, if you exclude the sunset of 2 large clients we have and their contracts, our retention rate for 2019 is 95%. And just to dig into that a little bit further, one of those clients was acquired by a larger company and the other was a business partner in the retail space that now views Rite Aid as a competitor. You asked the question, how does that compare to our competition. That's right in line with our competition's retention rate.

Bryan Cecil Hunt - *Wells Fargo Securities, LLC, Research Division - MD & Senior Analyst*

Very good. Then my second question is, when you look at retail, you're pulling lots and lots of levers, whether it's Amazon in-store lockers, self-checkout, endcap resets, you got this big merchandising initiative. In stores where you've got a majority of these services, one, how do those sales stack up on the front end relative to the -- to a control group? And as you've rolled out these services and test, what do you feel like the 2 or 3 biggest impacts have been from any changes made?

James J. Peters - *Rite Aid Corporation - COO*

It's a good question, and your use of control group reminds me by days at Geisinger, where we tested in a very academic sense many of our initiatives. I would say this that it's too early to tell on initiatives like Amazon Locker. What we can tell you is that it's certainly driving additional people into our stores. We can tell you that while our merchandising changes have already begun, they will really kind of have a much greater lift and be able to quantify that lift in the future as we deploy our long-term strategy. So I think the overall answer is that we certainly believe in a non-case control way that we are seeing, both increased foot traffic, increased consumer satisfaction. But too early to tell from a pure quantitative perspective.

Operator

We have time for one final question, and it is from Hale Holden from Barclays.

Hale Holden - *Barclays Bank PLC, Research Division - MD*

I was wondering if there was anything you guys did in your immunization program in the third quarter that was different year-over-year to drive the cadence that you saw. I know the flu hit slightly earlier in California than it had in prior years.

James J. Peters - *Rite Aid Corporation - COO*

Yes. Thanks for the question. We're really seeing improved impact from our Rite Care investment, the technology that our pharmacists use and frankly associates throughout the store use to kind of highlight opportunities for intervening for immunization opportunities. So that payoff has begun to show in an operational sense within our stores. And I think it's a key contributor to the strong results we've reported this quarter.

Heyward Rutledge Donigan - *Rite Aid Corporation - CEO & Director*

The team also does a lot of outreach, driven by what I'll call sort of an AI intelligence system that allows us to really outreach to people that we think are highly likely to want to get an immunization or need to get an immunization, and that has proven to be extraordinarily successful as well.

Hale Holden - *Barclays Bank PLC, Research Division - MD*

And then just one clarification. Heyward, I was wondering if you would be willing to put a number on what you thought the savings between the greater integration between Envision and the Rite Aid corporate is.

Heyward Rutledge Donigan - *Rite Aid Corporation - CEO & Director*

We are not prepared to do so. I mean I've only been here 4 months. We've just begun this restructuring. So we are still ourselves identifying this opportunity. And we'll certainly share more as we learn more.

Operator

There are no questions at this time. Presenters, please continue.

Heyward Rutledge Donigan - *Rite Aid Corporation - CEO & Director*

Well, thank you, everyone, for your questions. Before we end the call, I just want to again thank our team for all their hard work during this quarter. Unbelievably great results. And I'm even more optimistic about our future as I meet more members of our team. And we work together to build a new Rite Aid Corporation. It is a new day here at Rite Aid, and I'm looking forward to share more about our strategic vision in the near future. I hope everyone has a wonderful holiday season. And with that, we will now conclude today's call. Thank you.

Operator

Thank you again for joining us today. This concludes today's conference call. Thank you for participating. You may now disconnect.
